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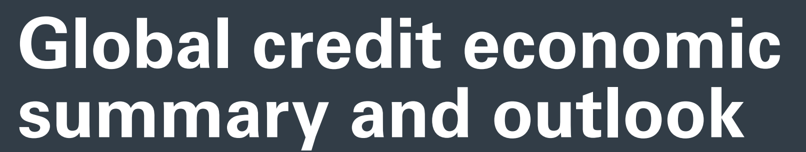


Fourth quarter 2019

Tortoise

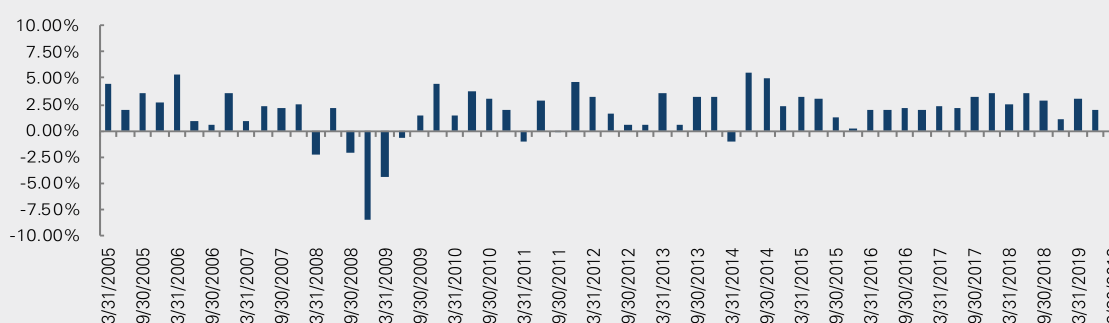
Global credit economic summary & outlook

Domestic

Summary

The U.S. economy remains incredibly resilient. GDP quarter-over-quarter seasonally-adjusted annual growth reached a better than expected 2.1% in the third quarter of 2019, and the consensus for GDP growth in the fourth quarter of 2019 is shaping up to again exceed 2%. If this proves to be true, 2019 will be the third consecutive year in which GDP grew more than 2%, and it will mark the longest such stretch of economic expansion since the financial crisis.

U.S. GDP growth, quarter-over-quarter seasonally adjusted annual rate



As of 9/30/2019. Source: Bloomberg

This prolonged period of solid GDP growth has brought the U-3 unemployment rate to 3.5%, its lowest level in five decades. Unsurprisingly, the incredibly healthy employment market has supported strong consumer spending which has been the main pillar of growth for the economy as a whole.

Away from the consumer, however, business investment remains challenged, a likely consequence of continuingly uncertain trade policies toward China. The flipside of the trade uncertainty is an improving U.S. global trade balance mainly because of declining imports. The Federal Reserve Bank of Atlanta projects that the improving U.S. global trade balance will add 0.8% to 0.9% to U.S. GDP growth in the fourth quarter of 2019. While not as impactful as the improving trade balance, recent inventory drawdowns have hindered GDP growth while increased government spending has been beneficial.

Inflation remains subdued. The U.S. Federal Reserve's 2% inflation goal, as measured by the Core Personal Consumption Expenditures Index, has not been met since the summer of 2018. Since then, inflation has persistently underwhelmed. Recently, the Federal Reserve appears increasingly concerned that a consistent shortfall in inflation versus its 2% target rate is unhealthy for the economy. Consequently, some economists believe the Federal Reserve may allow the economy to run "hot" in an effort to raise both realized inflation and inflation expectations.

The economy appears to have met the Federal Reserve's goal of achieving maximum employment. Both the "headline" unemployment rate (U-3), and the "underemployed" rate (U-6, which includes "marginally attached workers and those working part-time for economic reasons"), currently reside at multi decade lows of 3.5% and 6.7%, respectively.

Prior to the appointment of Jay Powell as Chairman, the Federal Reserve expressed concern regarding the low level of unemployment, because the assumption of an inverse relationship between unemployment and inflation, as depicted by the Phillips Curve, comprises a core element of the Federal Reserve's forecasting models. Notably, today's historically low unemployment has produced neither higher wage inflation nor broader price inflation. Consequently, it appears that the inverse correlation between unemployment and inflation has broken down. However, we suspect some economists and the Federal Reserve may have simply overestimated the causality between unemployment and inflation. At some

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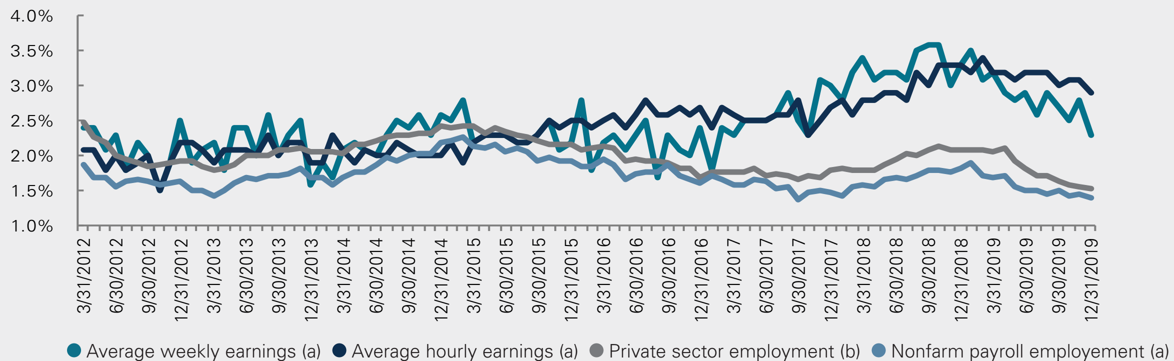
point, Chairman Powell and the Federal Reserve may adjust their forecasting models to recognize the lack of correlation between unemployment and inflation. If that occurs, and to the extent that the Federal Reserve does not fully inform the investment community of its revised methodology, its policy actions may at least temporarily become more difficult to forecast.

Finally, we note that while employment growth continues, it does so at a decelerating rate. The economy is incredibly dependent on an expanding consumer sector which will require continuing growth in employment and / or wages.

Employment trends, year-over-year change



As of 12/31/2019. Source: Bloomberg; (a) Bureau of Labor Statistics; (b) ADP

Outlook

On December 11, 2019, the Federal Open Market Committee ("FOMC") left rates unchanged and deemed its federal funds target range as "appropriate to support sustained expansion of economic activity, strong labor market conditions, and inflation near the Committee's symmetric 2% objective." In other words, rates may be on hold for an extended period of time and there is no bias with regard to the direction of the next move. While the FOMC has guided to a neutral rates outlook, the futures market currently assumes a single rate cut by the end of 2020. We believe the market is correct in this instance, in that the next move out of the Federal Reserve will likely be a rate cut rather than a hike, however, the timing of any action appears highly uncertain.

Our 2020 forecast anticipates that GDP growth will slow to between 1.5% and 2.0%, and that employment growth will slow but remain healthy. Under that scenario, we believe the 10-year U.S. Treasury Note will yield within a range of between 1.25% and 2.25%. We will monitor the economy and financial markets closely and adjust portfolio positioning accordingly.

International

Summary

Some overseas economies are beginning to display signs of bottoming. Importantly, the eurozone appears to be in the early stages of accelerating growth. Purchasing manager surveys appear slightly improved in response to easier monetary policy and increased discussion regarding potential fiscal stimulus. While we do not expect robust eurozone economic growth, it appears that the region will likely avoid a protracted economic slowdown or recession.

Asia also exhibits signs of economic recovery. The effects of decelerating economic growth in China are diminishing, spurring economic activity higher across the region. The export driven economies of South Korea, Taiwan, and to a lesser degree in Singapore appear most affected by this positive trend. However, the environment in China will remain subdued as regulators prioritize a reduction of financial leverage in the banking and shadow banking systems versus economic growth.

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The emerging markets in South America continue to face economic and political headwinds. Venezuela and Argentina remain deeply mired in economic dysfunction. Most economists expect reasonable economic growth in Columbia, Peru, and Chile, although Chile may lag somewhat. A potential upside for growth exists with regard to economic growth in Mexico, as the United States-Mexico-Canada Agreement continues to move forward; if it is finally enacted, supply chains will likely shift at the margin away from China towards Mexico.

Outlook

We believe global economies in aggregate will likely experience accelerating growth versus the U.S. This differential in the rate of acceleration should provide a backdrop for a weaker dollar versus most of the country's trading partners. Significant beneficiaries of a weaker dollar will include emerging economies, particularly those with sizable external financing burdens. We will be looking opportunistically to add exposure to these areas.

German rates have sold off (i.e., yields have increased) relative to other developed market sovereign yields; we believe this sell-off appears excessive. The United Kingdom will likely face challenges as it moves through BREXIT and beyond. Volatility in UK markets may provide both interest rate and currency opportunities for the portfolios in the near future.

Sector analysis

U.S. interest rates

During the fourth quarter 2019, longer-dated U.S. Treasury note yields increased, while yields on shorter duration bonds and Treasury bills fell alongside Federal Reserve rate cuts, and as a result, the yield curve steepened. The 10-year U.S. Treasury Note yield ended the quarter at 1.92%, a 30 basis point increase from the beginning of the period.

After the brief inversion in the third quarter, the 2-year versus 10-year U.S. Treasury yield curve closed the fourth quarter of 2019 at 25 points, its steepest level of the year. The move during the quarter suggests the market is less concerned about an imminent recession than it was just a few months ago.

In October 2019, the Federal Reserve cut interest rates by a quarter point for the third consecutive meeting, citing low inflation and uncertainty regarding global growth. The Federal Reserve does not appear overly concerned with the possibility that its stance may be too dovish as the Core Personal Consumption Expenditures Price Index remains well below the 2.00% range. In addition, the Federal Reserve also suggested it had finished cutting rates for the near future and turned neutral. The consensus during most of 2019 was that there were more rate cuts to come in 2020, however, this sentiment has changed and the market now expects rates to remain relatively flat heading into 2020.

During the fourth quarter, the yield on the 3-month Treasury Bill declined 17 basis points, ending the quarter at 1.55%. The 5-year U.S. Treasury Note yield increased to 1.69% from 1.55% at the end of the third quarter of 2019. The 10-year U.S. Treasury Note ended the quarter at 1.92% and the 30-year U.S. Treasury Bond yield increased to 2.39%. The 3-month U.S. Treasury Bill versus the 10-year U.S. Treasury Note spread began the quarter slightly negative at -16 basis points, but ended the quarter at 36 basis points.

Securitized products

The securitized markets found it difficult to keep pace with the strong rally in the credit markets to end the year. The agency mortgage sector experienced one of its best quarters in recent history, outperforming comparable U.S. Treasuries by 62 basis points. However, that performance lagged the rebound in riskier assets such as investment grade and high yield corporate bonds, which outperformed Treasuries by 221 basis points and 251 basis points, respectively. We have been adding to our agency MBS allocation and moved to neutral at year end. Given the attractive valuations, especially versus investment grade credit, we anticipate moving portfolio allocations to overweight in January. Valuations in the asset-backed and commercial mortgage sectors appear less compelling, although very positive fundamentals in consumer finance and commercial real estate support both markets. As a result, we maintain modestly overweight and selective positions in these two sectors. In the asset-backed sector, we continue to like subordinated prime and subprime auto bonds, retail credit cards, and AAA-rated CLOs. In commercial mortgages, we focus on moving toward higher-rated, seasoned bonds, which we believe compare favorably to similar credit or asset-backed alternatives.

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Investment grade credit

The fourth quarter of 2019 was a mirror opposite to the fourth quarter of 2018 with the investment grade credit markets picking up steam over the course of the quarter and the Bloomberg-Barclays U.S. Credit Index (the "Credit Index") generating 221 basis points of excess returns over similar duration U.S. Treasuries. The quarter began tepid with continued concerns around BREXIT, the trade war, slowing global growth, decelerating corporate earnings, and repo funding issues. However, additional central bank policy accommodation, including that of the FOMC in late October, some thawing trade tensions between the U.S. and China, a landslide victory for the UK Conservative Party, a continued global hunt for yield, and a substantial decline in foreign currency hedging costs propelled a strong credit rally into year end. The best-performing industries and sub-segments of the Credit Index, on an excess return basis, included telecom, cable, tobacco, oil refining, oil field services, and life insurance. The worst performing industries and sub-segments during the quarter comprised supranationals, foreign local governments, airlines, environmental, home construction, and construction machinery.

We remain modestly underweight investment grade credit due to rich valuations and weakening credit fundamentals, partially offset by decent supply and demand technicals. From a fundamental perspective, corporate revenue and EBITDA growth appear decelerating, U.S. and global growth are slowing, and the trade war is causing additional headwinds across many industries. However, we may see a modest rebound in revenue growth in 2020. Corporate balance sheet leverage remains a concern and has reached a post financial crisis peak, while interest coverage has reached a post crisis low although some post event risk BBB companies are deleveraging. Shareholder enhancement at the expense of debt holders remains pervasive through transformational M&A deals, as well as share buy backs. With credit yields within 25 basis points of their post financial crisis lows, there is a large incentive for companies to both term out any near-term maturity wall and engage in leveraging behavior.

Investment grade corporate bond demand technicals remain the largest beneficiary of the dovish central bank policy shift in the U.S. and Europe. The large supply of negative yielding global debt is pushing global investors into the highest yielding developed market bonds; that being those of the United States. The continued policy accommodation by the Federal Reserve combined with reduced repo funding pressures has caused foreign currency hedging costs to decline substantially for many investors in Europe and Asia, which in turn has translated into additional strong foreign demand for U.S. corporate bonds. Retail bond demand remains strong, although given where credit yields began the year and the strong inflows in 2019, we expect retail flows to decelerate versus last year.

From a supply standpoint, we expect issuance to remain extremely robust, especially during the first half of 2020, as companies take advantage of low interest rates prior to the U.S. presidential election. Given the strong spread rally experienced during the fourth quarter, investment grade credit valuations began 2020 only eight basis points wider than the post financial crisis spread low experienced in early 2018. However, given the roughly half year duration lengthening, as well as the substantially higher dollar price of the credit index since early 2018, we believe index credit spreads have reached the spread low after adjusting for these differences. As such, valuations are expensive from a historical perspective with index credit spreads only modestly tighter than the current environment on a sustained basis during the 2005-2006 and 1994-1997 time periods. The yield of 2.84% at the beginning of 2020 for the Bloomberg-Barclays U.S. Investment Grade Corporate Bond Index is within 25 basis points of its all time low reached over the last 45 years; however, it remains attractive for many foreign buyers relative to their local market alternatives.

In the near term, we expect continued strong technical demand tailwinds partially offset by extremely robust new issue supply. With valuations remaining very stretched and credit fundamentals mixed, we remain comfortable with a modest credit underweight and continue to focus on industry allocation and issuer selection as our primary driver of alpha within the sector.

High yield

The U.S. High Yield market, represented by the Bloomberg-Barclays U.S. Corporate High Yield Bond Index, finished 2019 with a strong rally, returning 2.0% in December, led by the year's underperformers (CCCs in general and energy sector credits, in particular) pushing fourth quarter and year 2019 total returns to 2.6% and 14.3%, respectively. Late in the fourth quarter, investors may have been positioning for 2020 by purchasing bonds that previously lagged in 2019, hoping to take advantage of the significant bifurcation that occurred during much of last year. Bonds rated CCC returned 5.0% in December (versus 1.9% for Bs and 1.2% for BBs) but still underperformed by more than 600 basis points for the year. Year 2019 total returns reached 15.5% for BBs, 14.8% for Bs, and 9.5% for CCCs. Since the end of the third quarter of

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2019, and through mid-January 2020, High Yield spreads tightened approximately 50 basis points to 315 basis points, just wide of the 303 basis point post-crisis tight of October 2018. At the sector level, December's energy rally, representing a 5.3% monthly total return, was not sufficient to offset earlier losses, leaving the sector's 2019 total return performance of 5.4% well short of the rest of the market, as no other sector posted less than a double-digit gain. Retail generated the top performing sector total return of 19.3%.

Technicals remain healthy, with the high yield market easily absorbing a robust new issue pipeline that has continued from the fourth quarter of 2019 into early 2020, including a recent resurgence in energy sector deals. On the fundamental side, the U.S. high yield default rate trended up to 2.63% at year end with a renewed wave of energy sector defaults, while credit metrics remained weak but stable again in the third quarter of 2019.

Investors will likely focus on earnings growth in 2020. However, valuations appear extremely challenged: spreads reside near post-crisis tights, yields are hovering around 5% (with about 50% of the market inside of 4%), and more than half the market trading above the next call price (including most of the BB sector). With the BB / B segment of the high yield market trading at post-crisis lows on spreads and a yield basis, loans appear to offer better relative value.

Leveraged loans

Leveraged loans, like U.S. High Yield, posted strong returns in December. The Credit Suisse Leveraged Loan Index returned 1.6% in December 2019, with average prices bouncing over a point and lower-rated tiers of the market leading the gains. December proved to be the second strongest month of total return performance in 2019 and brought fourth quarter and 2019 total returns to 1.7% and 8.2%, respectively. While leveraged loans trailed High Yield for most of 2019, due in part to substantial outflows as the Federal Reserve resumed easing, the asset class experienced its best annual performance since it returned 9.9% in 2016. As was the case for High Yield, December's 3.4% total return rebound for CCC-rated leveraged loans did not make up for an otherwise tough year for the ratings category, which sharply underperformed higher-quality loans. 2019 total returns were 2.7% for CCCs, 8.4% for Bs, and 9.1% for BBs. At the sector level, economic cycle and trade concerns remained evident, as the mining and energy sectors posted returns of -3.3% and -0.7%, respectively. The food, housing, and cable sectors all generated total returns above 10% in 2019, making these the best performing industries for the year.

Technicals remain challenged by retail outflows and tepid CLO demand. But with more issuers utilizing the High Yield market for funding, lower primary market issuance partially offset these trends in 2019. Leveraged loan default rates remain low at approximately 1.5%, but leverage and downgrades are climbing, indicative of late-cycle behavior.

With spreads tighter and LIBOR down, yields of approximately 6.25% are retesting three-year lows, but appear more attractive than high yield bonds rated BB and B. The relative value between loans and High Yield appears to favor loans, but issuer fundamentals and the potential for additional Federal Reserve rate cuts weigh on loan sentiment.

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